Charitable Planning and Organizations Group:

Philanthropy Planning and Choice of Entity in a Changing World

I. Type of Federal Charitable Classification After the Pension Protection Act

II. Choice of State Law Entity Type After the Pension Protection Act

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Type of Federal Charitable Classification
After the Pension Protection Act

Supporting Organizations

- A grant, loan, compensation, or "similar payment" (includes reimbursement of expenses) to a substantial contributor, to the contributor's relatives or to a business controlled by the contributor or family members is prohibited. § 4958(c)(3).

  Relatives include spouse, ancestor, sibling, child, grandchild, great-grandchild, or a spouse of one of such relatives.

  An entity in which a substantial contributor or a family member owns, separately or collectively, more than 35% of the total combined voting power (of a corporation), profits interest (of a partnership) or beneficial interest (of a trust or estate).

  Substantial contributor is any person who contributed or bequeathed an aggregate amount of more than $5,000 to the organization, if the amount is more than 2% of the total contributions and bequests received by the organization throughout its existence and before the end of the taxable year of the payment in question. For a trust, the term includes the creator of the trust regardless of the amount contributed by this person. § 4958(c)(3)(C).

  Reasonable compensation is not a safe harbor under this rule.

- Loans to any "disqualified person" are prohibited. § 4958(c)(3)(A)(i)(I).

  "Disqualified persons" include substantial contributors, family members and controlled entities, as well as officers, board members, and other managers. They are persons who, at any time during a five-year period ending on the date of the transaction, was in a position to exercise substantial influence over the affairs of the organization, along with that person's family members and controlled entities.

- Grants from private foundations no longer will qualify as qualifying distributions under § 4942 if a disqualified person with respect to the donor private foundation directly or indirectly controls the donee SO or any public charity supported by the SO. § 4942(g).

  Pursuant to Notice 2006-109, an organization is controlled by one or more disqualified persons with respect to a foundation if any such persons may, by aggregating their votes or positions of authority, require the supporting or supported organization to make an expenditure, or prevent the supporting organization or the supported organization from making an expenditure, regardless of the method by which the control is exercised or exercisable.

- Grants from private foundations described immediately above will be taxable expenditures under § 4945 unless expenditure responsibility is exercised. § 4945(d)(4)(A).

- For purposes of the excess benefit transaction rules applicable to public charities under § 4958, a "disqualified person" of a supporting organization is also a disqualified person of each and every supported organization.

Again, “disqualified persons” are persons who, at any time during a five-year period ending on the date of the transaction, was in a position to exercise substantial influence over the affairs of the organization, along with that person’s family members and controlled entities.

For purposes of this rule, only the excess above fair market value is subject to penalty.

Type III Supporting Organizations (Non-functionally integrated)

- Grants from private foundations no longer will qualify as qualifying distributions under § 4942. § 4942(g)(4).
- Grants from private foundations will be taxable expenditures under § 4945 unless expenditure responsibility is exercised. § 4945(d)(4)(A).
- Excess business holdings rules previously applicable only to private foundations under § 4943 are applicable. § 4943(f)(1), (3)(A). (**This rule also applies to Type II supporting organizations if they accept a contribution from a person (other than a public charity, not a supporting organization) who controls, either alone or with family members and/or certain controlled entities, the governing body of a supported organization of the SO.** § 4943(f)(1), (3)(B).)
- May not support foreign charities. § 509(f)(1).

  if supporting a foreign charity on August 17, 2006, may continue only until the first day of the organization's third taxable year beginning after August 17, 2006. § 509(f)(1)(B)(ii).
- Certain information must be provided to supported charities. § 509(f)(1).
- Public charity tax status will be lost if accept a contribution from a person (other than a qualified supported organization) who directly or indirectly controls a supported charity of the supporting organization, is a relative of such a person, or is an entity controlled by such a person (**this rule also applies to Type I supporting organizations**). § 509(f)(2).
- A "significant" minimum payout requirement (of a percentage of either income or assets) will be imposed in new regulations.

  Under the Advance Notice of Proposed Rulemaking, the proposed payout is the same 5% distribution requirement imposed on private foundations under § 4942.

A *functionally integrated Type III Supporting Organization* is one that performs functions or carries out purposes of the supported organization or that conducts activities that would normally be performed by the supported organization if the type III SO did not exist. § 4943(f)(5)(B).

In addition, a functionally integrated Type III SO may be required to meet certain tests of income or assets under the Advance Notice of Proposed Rulemaking, notwithstanding its definition as a Type III SO that is *not* required by the tax regulations to make payments to supported organizations. § 4943(f)(5)(B).

Expedited procedure exists to convert from § 509(a)(3) tax classification to § 509(a)(1) or (a)(2) tax classification under Announcement 2006-93.

Donor-Advised Funds

- Grants may not be made to any natural person or to any other person unless the community foundation exercises expenditure responsibility under § 4945. Excluded from this rule are grants to any organization described in § 170(b)(1)(A) except for grants to Type III, non-functionally integrated supporting organizations or to other supporting organizations in which a donor or advisor controls a supported charity. § 4966(c)(2)(A).

  Pursuant to Notice 2006-109, a supported organization is controlled by one or more donor or donor advisors (and any related parties) of any donor advised fund if any such persons may, by aggregating their votes or positions of authority, require the supported organization to make an expenditure, or prevent the supported organization from making an expenditure, regardless of the method by which the control is exercised or exercisable.

- A grant, loan, compensation, or "similar payment" (includes reimbursement of expenses) from a donor-advised fund to a donor, an advisor, or members of their families or businesses in which they have a substantial interest is prohibited. § 4958(c)(2).

- Penalties are imposed when a donor, advisor, or a person related to a donor or advisor receives a benefit from a grantee organization that is more than incidental. § 4967(a)(1).

  A benefit is more than "incidental" if it would reduce the recipient's charitable income tax deduction if she or he had made a contribution directly to the donee charity.

- Excess business holdings rules previously applicable only to private foundations under § 4943 are applicable. § 4943(e)(1).

  For this purpose, a "disqualified person" means a donor, donor advisor, member of the family of either, or a 35% controlled entity of any such person. § 4943(e)(2).

- Donors may claim tax deductions for contributions to a DAF only if they receive a written acknowledgment from the community foundation stating that the foundation has exclusive legal control over the contributed assets. §§ 170(f)(18)(B), 2055(e)(5)(B), 2522(c)(5)(B).

Definition of Donor-Advised Fund no longer includes funds that i) benefit only one charity or governmental unit or ii) makes grants for scholarships and similar purposes if the fund is advised by a committee wholly appointed by the community foundation and grants are made according to an "objective and nondiscriminatory" process that tracks the rules applicable to private foundations under § 4945 that make scholarship grants. § 4966(d)(2)(B). These funds, therefore, are not subject to excise taxes under new § 4966.

Pursuant to Notice 2006-109, employer-sponsored disaster relief assistance programs also are excluded from the definition of donor-advised fund under § 4966(d)(2)(A).

More to come: will DAFs be subject to minimum distribution requirements, and will retention of donor advisory rights continue to be consistent with the tax treatment of donations as completed gifts?

Private Foundations

- Grants from private foundations to any supporting organization no longer will qualify as qualifying distributions under § 4942 if a disqualified person with respect to the donor private foundation directly or indirectly controls the donee SO or any public charity supported by the SO. § 4942(g).
- Grants from private foundations described immediately above will be taxable expenditures under § 4945 unless expenditure responsibility is exercised. § 4945(d)(4)(A).
- Grants from private foundations to a Type III non-functionally integrated supporting organization no longer will qualify as qualifying distributions under § 4942. § 4942(g)(4).
- Grants from private foundations to a Type III non-functionally integrated supporting organization will be taxable expenditures under § 4945 unless expenditure responsibility is exercised. § 4945(d)(4)(A).
- The situations in which the § 4940 excise tax on net investment income are expanded. § 4940(c)(2).

    property that generally produces capital gains through appreciation, but not interest, dividends, rents, or royalties (such property arguably includes timberlands)

    capital gains and losses from the sale or other disposition of exempt-purpose or program-related investments

    income from notional principal contracts, annuities, and other substantially similar income from ordinary and routine investment

CHOICE OF STATE LAW ENTITY
AFTER THE PENSION PROTECTION ACT

- Upon review, counsel has decided that either a supporting organization or a private foundation makes sense

- As a result, counsel now needs to select the type of state law entity that would be appropriate for the supporting organization or private foundation:

    - Charitable Trust

        - Can have as few as one trustee
        - Higher fiduciary duties for trustees?
        - Lesser state law filing requirements?
        - Less rigid structure - good for families?
        - Less rigid structure - bad for disputes?
        - Doesn't fit in a Sarbanes-Oxley world

    - Nonprofit Corporation

        - In most states, 3 directors, but some variation
        - Business judgment rule plus?
        - Secretary of State filings
        - Precedent and statutory guidance on governance

    - Unincorporated Association -- ***let's just forget that one right now….***

- Supporting Organizations in Trust Form

    - Prior to the PPA, Type III Supporting Organizations were often created in Trust form -- Why?

        - In order to be a Type III Supporting Organization, the charity had to meet the "responsiveness test" and the "integral part" test. Treas. Reg. §1.509(a)-4(i)(1)(i).

        - There were two alternative ways to meet the "responsiveness test"

            - Have the officers, trustees or directors of the supporting organization on the governing body of, or otherwise involved in, the operations of the Supporting Organization, OR

            - If the supporting organization is a charitable trust under state law and the supported organization is named in the document and can compel an accounting, that is sufficient.

- PPA Change
    - Section 1241(c) of the PPA specifically provides that merely being a charitable trust with a named beneficiary who can demand an accounting is NOT sufficient to meet the responsiveness test.
    - BUT -- the responsiveness test remains….
    - SO -- how does a charitable trust meet the responsiveness test?

- Meeting the Responsiveness Test in a Charitable Trust World
    - The Responsiveness Test in detail:
        - One or more trustees are elected or appointed by the supported organizations OR
        - One or more of the trustees overlaps with the governing body of the supported organization OR
        - There is a "close and continuous working relationship" between the trustees and the governing body of the supported organization.
        - As a result of one of these relationships, the supported organization as a "significant voice in the investment policies, timing and making of grants, and otherwise directing the use or income of the assets of the Supporting Organization
    - Trust Administration and Fiduciary Issues
        - If you need to have an appointed or overlapping board -- how many Trustees are too many? Difficulties operating under state law --how many signatures? What kind of a vote? There are no officers?
        - Can you have just one Trustee with an advisory board - trouble for corporate trustees of supporting organizations?
        - Would acting on a non-binding advisory board be sufficient to have a "close and continuous" working relationship that has a "significant voice"
        - Duty of impartiality among beneficiaries - what happens when there are multiple supported organizations?
        - Limits on the ability to delegate investment authority
        - See the discussion of this issue in this Group's IRS comments dated January 3, 2008, located at http://meetings.abanet.org/webupload/commupload/RP529000/otherlinks_files/Comments-Sections509and4943.pdf and included herein as Attachment A.

ATTACHMENT A

COMMENTS OF INDIVIDUAL MEMBERS OF THE AMERICAN BAR ASSOCIATION, SECTION OF REAL PROPERTY, TRUST AND ESTATE LAW, CHARITABLE PLANNING AND ORGANIZATIONS GROUP, CHARITABLE PLANNING COMMITTEE, CONCERNING INTERNAL REVENUE CODE SECTIONS 509 AND 4943, IN RESPONSE TO IRS NOTICE OF PROPOSED RULEMAKING

I. INFORMATION ON THE DRAFT OF THIS RESPONSE

The following comments are submitted on behalf of the American Bar Association Section of Real Property, Trust and Estate Law. These comments have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

These comments were prepared by members of the Charitable Planning Committee (the "Committee") of the Charitable Planning and Organizations Group of the Trust and Estate Division of the Section of Real Property, Trust and Estate Law (the "Section") of the American Bar Association. Carol G. Kroch, Chair of the Charitable Planning and Organizations Group of the Section, supervised the preparation of these comments and participated in their preparation. The principal drafting responsibility was exercised by Stephanie B. Casteel, and substantive contributions were made by Sharon J. Bell. Others who participated were Mary Lee Turk, Elaine Waterhouse Wilson, Christopher Hoyt, Ramsay Slugg, and Nikola Toubia. These comments were reviewed by Linda B. Hirschson on behalf of the Section's Committee on Governmental Submissions.

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Although the members of the Section of Real Property, Trust and Estate Law of the American Bar Association who participated in preparing these comments have clients who would be affected by the federal tax principles addressed, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these comments.

II. BACKGROUND

The Pension Protection Act of 2006[1] (the "PPA") enacted Code Sections [2] 509(d) and 4943(f)(5), which define the term Type III supporting organization and distinguish between functionally integrated and non-functionally integrated Type III supporting organizations. New Code Section 4943(f)(5)(B) defines a functionally integrated Type III supporting organization as a Type III supporting organization that is not required, under regulations established by the Secretary, to make payments to supported organizations due to the activities of the organization related to performing the functions of, or carrying out the purpose of, such supported organizations. The PPA directed the Secretary to promulgate new regulations on the payments required by Type III supporting organizations that are not functionally integrated. Such regulations are to require non-functionally integrated Type III supporting organizations to make distributions of a "percentage of either income or assets to supported organizations (defined in new Code Section 509(f)(3) of the Code) in order to ensure that a significant amount is paid to their supported organizations."

The PPA also modified the responsiveness test as it applies to charitable trusts. A Type III supporting organization organized as a trust may no longer rely solely on its enforcement rights under state law to establish that it has a close and continuous relationship with the supported organization such that the trust is responsive to the needs or demands of the supported organization. Under the PPA, trusts that operated in connection with a publicly supported organization on August 17, 2006 had until August 17, 2007 to satisfy the modified responsiveness test under Treas. Reg. Section 1.509(a)-4(i)(2)(ii). For other trusts, the provision was effective on August 17, 2006.

Finally, the PPA enacted Code Section 509(f)(1)(A) to require Type III supporting organizations to provide each of its supported organizations with "such information as the Secretary may require to ensure that such organization is responsive to the needs or demands of the supported organization."

The Internal Revenue Service and Treasury (the "Government") issued on August 2, 2007 an Advance Notice of Proposed Rulemaking ("Notice") for "comments from the public." As described in the Notice, the Government intends to propose regulations that provide (1) the payout requirements for Type III supporting organizations that are not functionally integrated, (2) the criteria for determining whether a Type III supporting organization is functionally integrated, (3) the modified responsiveness test for Type III supporting organizations that are organized as charitable trusts, and (4) the type of information a Type III supporting organization will be required to provide to its supported organization(s) to demonstrate that it is responsive.

These comments are in response to the Notice. We appreciate the opportunity to comment on the regulations that the Government intends to propose. We appreciate your consideration of our comments and welcome an opportunity to discuss them further with you.

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[1] The Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (2006).

[2] References in these comments to Code Sections are to sections of the Internal Revenue Code of 1986 (the "Code"), as amended and, if preceded by "Treas. Reg. Section," to sections of the Treasury Regulations under the Code.

III. SPECIFIC COMMENTS SOUGHT IN ADVANCE NOTICE OF PROPOSED RULEMAKING

In the Notice, the Government invites comments regarding (1) the proposed payout requirement for non-functionally integrated Type III supporting organizations and (2) the proposed criteria for qualifying as a functionally integrated Type III supporting organization. In addition, the Notice specifically asks for comments on the following questions:

1. A Type III supporting organization that is not functionally integrated will be required to meet a payout requirement equal to the qualified distribution requirement of a private non-operating foundation under Code Section 4942. For organizations prohibited by their current governing instruments from distributing capital or corpus, what transition rules will provide such organizations a reasonable opportunity to amend their governing instruments or make other changes to comply with the law?

2. In addition, the proposed regulations will limit the number of publicly supported organizations to five. Existing organizations that support more than five organizations may continue to do so only if the supporting organization distributes at least 85 percent of its total required payout amount to, or for the use of, publicly supported organizations to which the supporting organization is "responsive." Are transitional rules needed with respect to this limitation since clearly this limitation may affect donee relations?

3. All Type III supporting organizations organized as charitable trusts will be required to meet the responsiveness test. Is transition relief needed since this rule is applicable as of August 17, 2007 to trusts already in existence?

4. The proposed regulations will provide rules for the form, content and timing of information Type III supporting organizations are required to provide their supported organizations. What information should be required?

5. The proposed regulations will define the term "functionally integrated Type III supporting organization" as a Type III supporting organization that meets: A) a "but for" test; B) an expenditure test; and C) an assets test.

The "but for" test requires that the activities engaged in for or on behalf of the supported organizations are activities to perform the functions of, or to carry out the purposes of, the supported organizations, and the supported organizations are in turn dependent upon the supporting organization for the type of support which it provides.

The expenditure test will require the use of substantially all of the lesser of the supporting organization's adjusted net income or five percent of the aggregate fair market value of all of its assets (other than assets that are used, or held for use, directly in supporting the charitable programs of the supported organizations) directly for the active conduct of activities that directly further the exempt purposes of the supported organizations.

The assets test requires the supporting organization to devote at least 65 percent of the aggregate fair market value of all its assets directly for the active conduct of activities that directly further the exempt purposes of the supported organizations.

What transition rules will provide organizations a reasonable opportunity to amend their governing instruments or make other changes to comply with the law?

IV. SUMMARY OF RECOMMENDATIONS

1. For non-functionally integrated Type III supporting organizations, we recommend an asset-based minimum distribution of 3 1/3 percent, similar to that under current law for private operating foundations. Any new annual minimum distribution amount should allow for the value of the supporting organization's assets to be calculated as an average over the prior three to five years.

2. We do not believe it is necessary for Treasury to put a limit on the number of organizations a Type III supporting organization may support. In lieu of such a limit, we suggest a test that requires the attentiveness of at least one supported organization to the supporting organization.

3. Type III supporting organizations organized as charitable trusts may not be able to meet the remaining responsiveness test without unavoidable conflict under state law. We recommend a facts and circumstances test be developed for such organizations that takes into account a trust's state law fiduciary duties. Further, we recommend transition relief for certain charitable trusts that were given transition relief under the Tax Reform Act of 1969.

4. If a Type III supporting organization has a single beneficiary identified in its exemption determination letter as the "lead beneficiary" with respect to which the attentiveness test is satisfied, we recommend that the regulations should limit the information distribution requirement to the lead beneficiary. If no such lead beneficiary is identified, we recommend that the Form 990 be provided to each supported organization, and that provision may be made by electronic distribution.

5. A functionally integrated Type III supporting organization, which may include a dedicated fundraising organization, should not be required to meet any test other than a "but for" test. Further, if a supporting organization is unable to satisfy the "but for" test only because state laws or regulations restrict the supported organization from engaging in an activity undertaken by the supporting organization, such supporting organizations should be classified as functionally integrated in the proposed regulations.

V. COMMENTS ON ISSUES RAISED IN ADVANCE NOTICE OF PROPOSED RULEMAKING

1. *The Five Percent Payout Requirement for Non-Functionally Integrated Type III Supporting Organizations*

Section 1241(d) of the PPA directed Treasury to promulgate new regulations requiring non-functionally integrated Type III supporting organizations to distribute "a percentage of either income or assets to supported organizations…. in order to ensure that a significant amount

is paid to such organizations."[3] The staff of the Joint Committee on Taxation [4] has indicated that the concern with the existing income-based payout requirement for such organizations is that it does not result in a significant amount being paid to the charity if the assets held by a supporting organization produce little or no income, especially in relation to the value of the assets held by the organization, and as compared to amounts paid out by non-operating private foundations.[5]

The Government proposes to apply to non-functionally integrated Type III supporting organizations the five percent payout requirement applicable to non-operating private foundations contained in Code Section 4942, but such an approach ignores the significant difference between effective supporting organizations and private foundations. Perhaps the most significant feature of a supporting organization is its close affiliation with its supported charities, rather than with its donors. Private foundations are donor-focused vehicles, providing flexible mechanisms for donors to meet various philanthropic goals by funding any number of charitable organizations in any given year. Private foundations are not required to designate specific beneficiary organizations, and they therefore have the ability to pick and choose from a potentially unlimited pool of beneficiary organizations each year. The amount of support private foundations provide to particular organizations can vary widely from year to year according to the shifting priorities of the foundation's management; often private foundation funding is given only for a single project or for a few years.

Supporting organizations, by contrast, are intended to be charity-focused entities, whether they are created by the supported charities themselves or by interested benefactors. A large measure of donor discretion is forfeited when the supporting organization relationship is created. The supporting organization is bound to its designated supported public charities, often in perpetuity and excluding the donor from even an indirect control relationship.[6] In the case of Type III supporting organizations, the supported public charities must be specifically named in their organizing documents— thus ensuring an ongoing relationship between a supporting organization and specific supported organizations.[7] Although the Type III relationship has been identified as the "loosest" of the three supporting organization relationships, it is still a much closer relationship than the typical relationship between a private foundation and its grantees. Unlike the typical private foundation, a supporting organization acts as an integral part of its designated supported organizations, consistently providing functional or financial support over the long term.

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[3] PPA, § 1241 (d), 120 Stat. at 1103; Staff of the Joint Committee on Taxation, Technical Explanation of H.R.4, The "Pension Protection Act of 2006," as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006, at 360.

[4] Staff of the Joint Committee on Taxation, Technical Explanation of H.R.4, The "Pension Protection Act of 2006," as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006.

[5] *Id.* at 360, n.571.

[6] Treas. Reg. § 1.509(a)-4(d).

[7] Treas. Reg. § 1.509(a)-4(d)(4).

The consistent, long-term support provided by a supporting organization is a significant advantage to its supported public charities. When beneficiaries have a reliable, sustainable source of support, they are able to focus more time and energy on fulfilling their charitable mission rather than fundraising. In addition, the long-term support of a supporting organization, like having a permanent endowment, allows beneficiaries to conduct long-term research and initiate programs on which their service populations can rely without fear of interruption. Many public charities prefer predictable, sustainable and increasing distributions from a dedicated supporting organization rather than short-lived—even if large—distributions from private foundations and the uncertainty of hand-to-mouth fundraising.

In our view, an asset-based payout requirement for Type III supporting organizations of five percent is too high. To require such a payout in effect ignores the differences between supporting organizations and private foundations. Further, because Type III supporting organizations are relied upon by their supported organizations as a source of long-term support for their charitable programs—much as an endowment would be—a five percent fixed payout requirement likely would not preserve a supporting organization's ability to continue to provide comparable levels of support in the future. The benefits of a permanent endowment are not a novel discovery; they are age-old and well-documented. Like a permanent endowment, a supporting organization can provide beneficiaries with a reliable source of support that ensures financial stability and security even in fluctuating market conditions. Historically, inflation has averaged approximately three percent per annum. For a permanent endowment to maintain its inflation-adjusted value, the principal must be permitted to grow by that much each year. At least one empirical study has demonstrated that a five percent annual distribution rate exposes the portfolio to a high probability of failing to meet that objective.[8]

We agree that non-functionally integrated Type III supporting organizations operating appropriately as an integral part of their supported organizations should be making significant annual distributions for their support-- and in most cases, supporting organizations are doing just that. This requirement must be balanced, however, with the need to preserve a supporting organization's ability to provide consistent support for its supported organizations and their charitable activities in the future. The key, therefore, is to select a minimum percentage payout rate that is sustainable—thus assuring both significant support for charitable programs now and undiminished purchasing power of the long-term support to the supported organizations.

Where there are minimum payout requirements in the Code or Regulations for organizations that are committed to particular charitable programs, they are set at rates lower than the five percent minimum payout rate for private foundations. For example, private operating foundations, which are engaged in charitable activities but may be controlled by a single donor or family, are generally required to annually distribute a minimum of three and one-third percent of the value of their endowments unless such endowments (including all assets not used directly in their charitable programs) are small (35 percent or less of their assets).[9]

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[8] Cambridge Associates, Inc., *Sustainable Payout for Foundations: A Study Commissioned by the Council of Michigan Foundations, available at* http://www.cmif.org/documents/payout.pdf (last updated April, 2004).

[9] Code § 4942(j)(3) and Treas. Reg. § 53.4942(b)-2. A private operating foundation also is not subject to this 3 1/3 percent minimum distribution requirement if it has sufficiently broad sources of support.

Significantly, Congress rejected imposition of the private non-operating foundation "minimum investment return" payout requirement (currently five percent) on such organizations, instead determining that two-thirds of that amount was sufficient to guard against insignificant expenditures on their charitable programs relative to the size of their endowments.[10] Similarly, a medical research organization, which like a private operating foundation need not have broad public support or accountability, is required to expend "a significant percentage of its endowment" annually on its activities if its endowment is larger than half of its assets. In drafting this requirement, Treasury followed Congress's lead and determined that a minimum payout of three and one-half percent is "a significant percentage" of the organization's endowment.[11] These payout rates allow the organizations to support their current operations at a level commensurate with their assets while permitting increases in principal sufficient to support future operations in the face of inflation. Payout rates for supporting organizations should similarly enable them to provide funding for the charitable programs of the supported organizations both now and in the future.

We recommend a minimum payout requirement for non-functionally integrated Type III supporting organizations that is similar to the current law for private operating foundations and medical research organizations, *i.e.*, a minimum distribution of three and one-third percent of asset value.[12] This recommendation was set forth in the American Bar Association's Section of Taxation's comments in response to IRS Notice 2007-21 on Treasury Study on Donor Advised Funds and Supporting Organizations, submitted by Susan Serota to Mr. Kevin Brown, Acting Commissioner of the Internal Revenue Service, on August 1, 2007. As expressed in this letter, three and one-third percent is a payout rate that should appropriately balance the competing objectives of ensuring that a significant amount goes to the supported organizations and avoiding erosion of the real inflation-adjusted value of the permanent endowments of Type III supporting organizations to the detriment of future generations that would result from imposition of a five percent minimum distribution requirement.[13]

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[10] Staff of Joint Comm. on Internal Revenue Taxation, 91st Cong., *General Explanation of the Tax Reform Act of 1969,* at 60-61 (Comm. Print 1970). If its income is sufficiently high, such a private operating foundation will be required to pay out more than this minimum amount, as all private operating foundations must expend 85 percent of adjusted net income-- up to a maximum payout requirement of 4.25 percent of their endowment. Treas. Reg. § 53.4942(b)-1(a)(1)(ii). We note that this maximum payout percentage is still substantially lower than the minimum payout requirement of five percent being proposed for non-functionally integrated Type III supporting organizations.

[11] Treas. Reg. § 1.170A-9(c)(2)(v)(b). This appears to be a rounded up equivalent of the "two-thirds of the minimum investment return" private operating foundation payout standard that was initially included in the proposed regulation.

[12] An additional requirement that supporting organizations distribute at least 85 percent of net income up to a maximum of 4.25 percent of endowment assets, also would be consistent with the current private operating foundation distribution requirement. However, for ease of administration, we recommend simply adopting the 3 1/3 percent minimum payout requirement.

[13] ABA Comments in Response to IRS Notice 2007-21 on Treasury Study on Donor-Advised Funds and Supporting Organizations, at p. 9.

In addition, because most public charity beneficiaries of supporting organizations prefer predictable, sustainable, and increasing distributions rather than distributions that may vary widely from year to year, the regulations creating a new annual minimum distribution amount should allow for the value of the supporting organization's assets to be calculated as an average over the prior three or five years, rather than over the prior year, as is the case for private foundations. Using the average fair market value for the immediately preceding 12 or 20 quarters would smooth the effects of market volatility—thereby moderating the year-to-year variance in supporting organization required distributions.

This moderation could be accomplished by providing two different methods for calculating the annual minimum distribution amount. The first method could involve the multiplication of the applicable percentage by the fair market value of assets at the immediately preceding fiscal year-end. The second method could involve the multiplication of the applicable percentage by the average fair market value of assets over the immediately preceding 12 or 20 quarters. The first method provides a simple straightforward calculation formula that would lessen the burden of compliance and enforcement. Although a bit more difficult to calculate, the second method creates an important hedge for the supported beneficiaries against sudden downward shifts in the market. A smoothing mechanism similar to the one proposed would protect similarly situated beneficiaries, their employees, and the persons and communities they serve from large drops in annual funding due to a plunge in financial markets. For example, if there were a large drop in the value of the supporting organization's assets in one year, and the asset values recovered during the following year or two, the required distributions to supported organizations would remain relatively stable, decreasing only moderately, if at all, after the downturn and increasing moderately during the upswing. Using an average asset value over three to five years to calculate the minimum distribution amount thus makes it easier for the beneficiaries to project future distributions and plan accordingly—thereby increasing financial stability for the beneficiary organizations.[14]

Although some have questioned the wisdom of perpetual existence of supporting organizations, continuing support from a supporting organization can provide a transformative base from which the supported beneficiaries can advance their charitable purposes. With the assurance of annual distributions to sustain vital programs and operations, a supported beneficiary can gradually evolve from a paycheck-to-paycheck operation with a good idea to become a regional or national leader in its philanthropic endeavors because it has the economic wherewithal to implement its vision. Often private foundations are willing to provide seed money for an innovative philanthropic project but do not want to provide ongoing grants to carry on operations. Instead, private foundation funders will move on after a few years, funding the next organization with the next good idea. A supporting organization, however, is designed to operate hand-in-hand with the supported charities, providing sustaining support while protecting the corpus so that the charitable operations of the supported organizations can continue indefinitely.

[14] The Tax Code and Treasury Regulations employ similar smoothing mechanisms in a variety of exempt organizations contexts. Perhaps most relevant, Treasury Regulation § 53.4942(b)-3(a) allows private operating foundations to meet their payout requirements based on total expenditures and income over a four-year period ending in the year in question.

Finally, it is important to note that if the eventual minimum distribution regulations require the encroachment of principal, many non-functionally integrated Type III supporting organizations will have difficulty complying because they are prohibited by their governing documents from distributing principal. This is especially true in the case of older Type III supporting organizations created as trusts that require the payment of "income only" to its supported organizations. Before invading the trust corpus, such supporting organizations will be required under state law to seek trust modifications (or other measures), which can be accomplished only after joining all potential charitable beneficiaries as parties and, most likely, naming the state's Attorney General as a party *parens patria*. Some of these older trusts have in excess of 100 supported organizations. It will be necessary to address and determine how a minimum distribution that is more than income will be divided among the permissible charitable beneficiaries. If the governing document does not contemplate encroachment of principal, the parties involved must determine in what amounts and shares the principal will be distributed. This determination will be an extremely difficult task for a supporting organization with multiple supported organizations, all of whom have competing and conflicting interests. Sufficient time must be allowed for state proceedings to be concluded so that any annual payout requirement is not in conflict with the governing provisions of an "income only" Type III supporting organization.

2. *The Five Supported Organization Limit*

Section 1241(d) of the PPA directed Treasury to promulgate new regulations requiring non-functionally integrated Type III supporting organizations to distribute "a *percentage of either income or assets* to supported organizations…. in order to ensure that a significant amount is paid to such organizations." Nowhere in the PPA or the legislative history is there any suggestion that Congress intended to impose an arbitrary limit on the number of supported organizations benefited by a single supporting organization. In fact, we fail to see how a limit on the number of supported charities will in any way increase the total amount distributed by the supporting organization. Although a similar limitation was included in early Senate versions of the legislation, Congress ultimately decided not to impose a limit of five supported organizations on Type III supporting organizations.[15] Thus, we do not see any need for Treasury to now impose this limit rejected by Congress. As long as a supporting organization is paying a significant amount to its supported organizations, it should not be necessary to limit the number of supported organizations.

Further, setting the publicly supported organization limit at five seems arbitrary, and it bears no relation to whether it is possible for a Type III supporting organization to be accountable to more than five supported organizations. A large supporting organization may well be able to provide meaningful support to a large number of supported organizations. Similarly, a small organization might well not be able to support the five it is allowed. From a policy and administration prospective, the key inquiry should be whether there is at least one organization that is receiving sufficient and significant support from the supporting organization to ensure accountability. It is not necessary for a Type III supporting organization to be accountable to each and every organization it supports if there is at least one organization with a

[15] *See* S.2020, 109th Cong. § 341(b) (ES, 2005) and HR 4297, 109th Cong. § 241(b) (EAS, 2006).

sufficient stake in the accountability of the supporting organization to ensure its proper operation.

3. *All Type III Supporting Organizations Organized as Charitable Trusts Will be Required to Meet the Responsiveness Test*

The PPA stated that for purposes of Code Section 509(a)(3)(B)(iii), an organization which is a trust shall not be considered to be organized "in connection with" *solely* because 1) the charitable the trust is a charitable trust under state law, 2) the supported organization is a beneficiary of such trust, and 3) the supported organization has the power to enforce the trust and compel an accounting. In other words, it no longer will be possible for a supporting organization organized as a charitable trust to meet the responsiveness test under Treas. Reg. Section 1.509(a)-4(i)(2)(iii) on that basis alone. Instead, under the proposed regulations, all Type III supporting organizations organized as charitable trusts will be required to meet the alternate responsiveness test under Treas. Reg. Section 1.509(a)-4(i)(2)(ii). The PPA did not mandate this alternate test to be the appropriate test for charitable trusts, and for several reasons, this alternate test is not an appropriate test for charitable trusts.

Under the responsiveness test of Treas. Reg. Section 1.509(a)-4(i)(2)(ii), a Type III supporting organization organized as a charitable trust must demonstrate the necessary relationship between its trustees and those of its supported organizations, and further show that this relationship results in the officers, directors or trustees of its supported organization having a significant voice in the operations of the supporting organization. This test requires a charitable trustee to give its supported organizations a significant voice in the operations, including investments, of the charitable trust.

When the responsiveness test was first defined in the Treasury Regulations after Code Section 509(a) was enacted by the Tax Reform Act of 1969, two alternate tests, rather than one, were proposed, because of the recognition that Type III supporting organizations organized as charitable trusts are vastly different from those organized as other types of entities. Charitable trusts are creatures of state law, which imposes fiduciary and other duties on charitable trustees. Requiring charitable trusts to meet the alternative responsiveness test of Treas. Reg. Section 1.509(a)-4(i)(2)(ii) sets up a potential conflict between the federal regulations and state law imposed duties, especially if there are multiple trust beneficiaries.

State laws vary with regard to the duties of trustees of charitable trusts. Most states impose a duty of impartiality to trust beneficiaries, but states vary widely with regard to a trustee's ability to delegate investment authority. In some states, trustees of charitable trusts owe a standard of fiduciary duty to its beneficiaries that is higher than their board of director counterparts of charitable corporations. Because of potential breach of fiduciary duty claims, it is institutional policy of most, if not all, corporate trustees that they maintain the responsibility for financial decisions. Even if state law allows a trustee to delegate financial authority, state law may impose a continuing duty (and potential liability) on the trustee to be responsible for and oversee the delegation. How can variations in state law be taken into account in imposing a requirement that trust beneficiaries have a significant voice? From a practical standpoint, how

can trust beneficiaries be given a significant voice in investment policy if it is the trustee's fiduciary duty to make investment policy?

It may be impossible for the trustee of a charitable trust organized as a Type III supporting organization to give its competing beneficiaries, who cannot act independently and objectively with regard to the direction of investment policy, a significant voice in investment policy (if in order to have a "significant voice," some sort of control or enforcement right to have such advice taken must be present) and yet maintain and fulfill its state law fiduciary duties to the trust. It is the recognition of the state law fiduciary considerations of a charitable trustee that resulted in the approval of an alternative test for charitable trusts in the first place. To illustrate the trustee's position, if a supporting organization supports more than one supported organization, whose investment preferences are likely to be based on what produces the most return for it, how can multiple beneficiaries with competing interests all have a significant voice in the supporting organization's investment policy? Does a supported organization have a significant voice in investment policy if its preferences are not followed? If all supported organizations had a representative on some sort of trust advisory board, would none have a significant voice? Would each of them have a significant voice? If a larger number of representatives of a particular supported organization participated on a trust advisory board, then would the other supported organizations not have a significant voice? In short, what is a "significant voice?" It may not be possible for a charitable trust structured and governed under state law to permit multiple supported organization beneficiaries with competing interests to make financial decisions for the entire group of beneficiaries. Not only does this produce conflict, it introduces an inherent conflict for a trustee who, under state law, has a duty of impartiality.

Under the law before enactment of the PPA, if a charitable trust was not responsive to the needs of one of its beneficiaries, and state law allowed such beneficiary to enforce the trust, then by definition such beneficiary had the ability to cause the supporting organization to be responsive and fulfill its duties under the trust instrument. We recognize, however, that the PPA disallowed this responsiveness test to be the *sole* demonstration of responsiveness for charitable trusts. But nothing in the PPA disallows the status as a state law charitable trust from being *evidence* of responsiveness, and indeed, Congress could have repealed the charitable trust responsiveness test entirely instead of stating that it alone could not demonstrate responsiveness. Therefore, the right of a beneficiary to enforce a charitable trust under state law should be relevant to determining responsiveness. Further, the PPA does not require charitable trusts organized as Type III supporting organizations to meet the remaining alternate responsiveness test. Instead, a second, alternate test for charitable trusts should be developed, based on facts and circumstances, that recognizes not only the state laws applicable to charitable trusts, but that such laws will vary among states.

In addition, many older charitable trusts cannot satisfy the proposed responsiveness test. Supporting organizations established before November 20, 1970 were grandfathered under the "transitional rule" of Treas. Reg. Section 1.509(a)-4(i)(4). Under this rule, a charitable trust is considered to meet the integral part test if, for taxable years beginning after October 16, 1972, written annual reports are provided to each public charity and the trust meets all of the five following requirements on November 20, 1970, and all years thereafter:

1. all the unexpired interests in the trust are devoted to one or more charitable purposes, and a charitable deduction was allowed with respect to these interests;
2. the trust was created prior to November 20, 1970 and did not receive any grant, contribution, bequest or other transfer on or after such date;
3. the trust is required by its governing instrument to distribute all of its net income currently to a designated publicly supported beneficiary organization (where the instrument designates more than one, all of the net income must be distributable and must be distributed currently to each of the beneficiaries in fixed shares pursuant to the governing instrument);
4. the trustee of the trust does not have discretion to vary either the beneficiaries or the amounts payable to the beneficiaries; and
5. none of the trustees would be disqualified persons (other than by reason of being foundation managers) with respect to the trust if such trust were treated as a private foundation.

Under the PPA, such charitable trusts may no longer meet the requirements of Treas. Reg. Section 1.509(a)-4(i)(2)(iii) to satisfy the responsiveness test, but it may not be possible for them to meet the responsiveness test currently proposed in the Notice. For example, one large financial institution has indicated that it serves as trustee of approximately 2,200 Type III supporting organizations organized as charitable trusts, which will convert to private foundation status as of August 17, 2007. Among other things, such trusts will become subject to the excise tax on net investment income under Code Section 4940, which will reduce the amounts of money available for distribution to supported charities. One national charity alone, beneficiary of some 139 trusts at this financial institution, already has expressed concern that the failure of the responsiveness test for Type III supporting organizations for which a corporation serves as trustee will result in over $1 million annually being diverted from charitable programs that otherwise would be supported to excise tax on net investment income.

For this reason, we recommend that Type III supporting organization organized as charitable trusts that were given transition relief from the private foundation rules enacted by the Tax Reform Act of 1969 also be given transition relief with regard to the revised responsiveness test to be proposed under the PPA.

4. *Information Type III Supporting Organizations are Required to Provide*

Section 1241(b) of the PPA amended Code Section 509 to condition Type III supporting organization status, in part, on it furnishing "to each supported organization" certain information that the Secretary may require to ensure responsiveness. The proposed regulations will provide rules for the form, content and timing of the information Type III supporting organizations will be required to provide their supported organizations. Whatever information is required, Treasury should be mindful of the potential administrative burden and additional costs that an information distribution requirement may force on supporting organizations that support many organizations.

For a Type III supporting organization with a single beneficiary identified in its exemption determination letter as the "lead beneficiary" with respect to which the "attentiveness test" is satisfied, the new regulations should limit the information distribution requirement to the

lead beneficiary. If no lead beneficiary is designated in the exemption letter, such that information must be distributed to all supported organizations, the proposed regulations should allow for electronic distribution via the internet. By allowing electronic distribution, costs of otherwise producing and mailing information to each supported organization will not diminish total funds available for grants. With regard to the type of information that must be provided, we recommend the supporting organization's annual tax return (Form 990) be provided.

5. *Definition of Functionally Integrated Type III Supporting Organization*

The Notice states that under the proposed regulations, a functionally integrated Type III supporting organization will be defined as a Type III supporting organization that meets (A) the "but for" test in existing Treas. Reg. Section 1.509(a)-4(i)(3)(ii); (B) an expenditure test consistent with Code Section 4942(j)(3)(A); and (C) an assets test consistent with Code Section 4942(j)(3)(B)(i). It is expected that the expenditure test will require a functionally integrated Type III supporting organization to use substantially all of the lesser of (a) its adjusted net income or (b) five percent of the aggregate fair market value of all its assets (other than assets that are used, or held for use, directly in supporting the charitable programs of the supported organizations) directly for the active conduct of activities that directly further the exempt purposes of the organizations it supports. The assets test will require the organization to devote at least 65 percent of the aggregate fair market value of all its assets directly for the active conduct of activities that directly further the exempt purposes of the organizations it supports. Finally, the proposed regulations will not permit a functionally integrated Type III supporting organization to qualify as functionally integrated by using the endowment or support tests that are available to private operating foundations as alternatives to the proposed assets test.

Again, and as stated above, for non-functionally integrated Type III supporting organizations, Section 1241(d) of the PPA directs the Secretary to require such organizations to make distributions of a percentage of *either* income or assets. But the definition of functionally integrated Type III supporting organizations, the more favored of the two types of Type III supporting organizations, requires an organization to satisfy *both* an income and an assets test. The proposed regulations appear to conflict with Congressional intent by defining a functionally integrated Type III supporting organization as one that must satisfy more requirements than the payout requirement imposed by the PPA on non-functionally integrated Type III supporting organizations.

Further, the Notice states that the new categories of Type III supporting organizations, functionally integrated and non-functionally integrated, reflect the distinction between those organizations that meet the "but for" test (the integral part test of Treas. Reg. Section 1.509(a)-4(i)(3)(iii)) and those that meet the attentiveness test (which is part of the alternate integral part test of Treas. Reg. Section 1.509(a)-4(i)(3)(iii), which includes a requirement of the payment of substantially all income). New Code Section 4943(f)(5)(B) created by the PPA specifically defines a functionally integrated Type III supporting organization as a supporting organization that is *not required* under regulations established by the Secretary to make payments to supported organizations due to the activities of the organization related to performing the functions of, or carrying out the purposes of, such supported organizations. Yet the Notice proposes regulations that not only would impose a payout requirement on functionally integrated Type III supporting organizations, but also would combine the two alternate integral part tests.

The Notice states that although the "functionally integrated" language appears similar to the "but for" prong of the "operated in connection with" relationship, the Staff of the Joint Committee on Taxation in its technical explanation of Section 4943 notes that the "but for" test is not sufficiently stringent to ensure a sufficient nexus between the supporting and supported organizations.[16] In particular, the Technical Explanation states that in revising the Type III supporting organization regulations, the Secretary "shall strengthen the standard for qualification as [a type III supporting] organization that is not required to pay out."[17] Although the Congress did not explicitly prohibit an expenditure test for functionally integrated Type III supporting organizations, it seems implicit in the statutory reference to an organization "not required to pay out" that an expenditure test is incompatible with Congressional intent.

The proposed definition of a functionally integrated Type III supporting organization essentially uses as a model the definition of a private operating foundation. The proposed definition, however, does not include the option to satisfy the endowment test or support test as alternatives to the assets test. Thus, a functionally integrated Type III supporting organization is subject to a stricter definition than that imposed for a private operating foundation. Although it is true that functionally integrated Type III supporting organizations conduct operations similar to those of private operating foundations, a functionally integrated Type III supporting organization has less discretion in its governance and operations than does a private operating foundation. Specifically, a Type III supporting organization may not be controlled by its donors, as may the private operating foundation. In addition, the Type III supporting organization must be operated solely for the benefit of, and be responsive to the needs of, its specified publicly supported charities and their charitable programs. Because of this requirement, the publicly supported organizations generally will be attentive to, and exercise oversight of, their Type III supporting organizations. Thus, the tests for qualifying as a functionally integrated Type III supporting organization should not be more strict than the tests for being a private operating foundation. Such a result would go against the reason Type III supporting organizations were created under Section 509(a) by the Tax Reform Act of 1969.

Further, the assets test under the proposed regulations would make is impossible for a fundraising entity closely affiliated with a single supported organization to qualify as a supporting organization unless a majority of its board overlaps with (Type II) or is appointed by (Type I) the supported organization. Clearly, fundraising is an essential activity that, but for the supporting organization, would be carried on directly by the supported organization. If such a fundraising organization does not have sufficient public support to convert its status from a Section 509(a)(3) supporting organization to a Section 509(a)(1) publicly supported charity (often the case due to a few generous donors), it becomes difficult for it to receive grants from private foundations, and it becomes subject to additional restrictions. Many important Type III supporting organizations would "fall through the cracks" even if they are very closely connected to and dedicated to a supported organization and meet the "but for" test if they cannot meet the assets test.

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[16] *See* Staff of the Joint Committee on Taxation, Technical Explanation of H.R. 4, the "Pension Protection Act of 2006," as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006, at 360, n.571.

[17] Id.

For example, consider a fundraising organization as part of an integrated system that includes multiple charities. Because a Type III supporting organization that oversees or facilitates the operation of such integrated system appoints the board of the fundraising entity, it cannot qualify as a Type I or Type II supporting organization. Or consider a supported organization that does not want to be affiliated with a Type I or Type II supporting organization in order to keep the endowment away from year to year operations for budget control and long term planning. The fundraising entity is performing a function that "but for" its existence the supported charity would perform, and the fundraising entity otherwise meets the integral part test. Such a fundraising organization, since it is not an "operating" organization, would not necessarily be able to satisfy the assets test applicable to private operating foundations, and as a type of charitable organization favored over private foundations, it should not have to. Yet such a fundraising entity, if classified as a non-functionally integrated Type III supporting organization, would have a difficult time serving one of its primary purposes: attracting grants for the integrated system from private foundations. Therefore, we believe that fundraising supporting organizations generally meet the "but for" test, and they should be permitted to rely on the "but for" test to establish that they are functionally integrated.

Finally, we note that many Type III supporting organizations were created by state universities in order to perform research that the universities could not otherwise perform themselves due to applicable state laws or regulations. Such a supporting organization technically may not be performing activities that "but for" the supporting organization would be performed by the university, since the university could not legally perform such activities. Such supporting organizations are analogous to title holding companies that historically were created to hold real property because of state law restrictions on the holding of property by nonprofit organizations. A title holding company technically was not performing an activity that "but for" its existence, the nonprofit would perform, since under state law the nonprofit could not legally perform such activity. Certainly it is not intended that this type of supporting organization be treated as a non-functionally integrated Type III supporting organization. Although we submit that a "but for" test alone is adequate for a functionally integrated Type III supporting organization, we suggest that this test be modified so that it also recognizes supporting organizations that perform an activity of the supported organization, which the supported organization would perform "but for" the supporting organization *and* "but for" laws or regulations providing restrictions applicable to the supported organization.

In summary, in defining a functionally integrated Type III supporting organization as one that must satisfy both an income and an assets test, Treasury unnecessarily made such an organization satisfy stricter requirements than the payout requirement imposed on non-functionally integrated Type III supporting organizations. Indeed, any type of a payout requirement for a functionally integrated Type III supporting organization would seem to contradict the express description of a functionally integrated Type III supporting organization in the PPA. We therefore recommend that a functionally integrated Type III supporting organization be defined as one that meets the "but for" test alone, without any additional payout requirement. By definition of the "but for" test, a fundraising supporting organization should have a sufficient nexus with its supported organization. The imposition of either an expenditure test or an assets test imposes a requirement on functionally integrated Type III supporting organizations that is specifically intended only for non-functionally integrated Type III supporting organizations under the PPA. The more favored functionally integrated Type III

supporting organization should not be required to meet more requirements than a non-functionally integrated Type III supporting organization. Further, we submit that the "but for" test should provide for i) the inclusion of fundraising organizations dedicated solely to a supported organization or related organizations (such as an integrated system) that meet the "but for" test, and ii) the inclusion of supporting organizations that meet the "but for" test "but for" laws or regulations providing restrictions applicable to the supported organization.

VI. CONCLUSION

Our hope is that additional consideration by the Treasury and Internal Revenue Service of proposed Treasury Regulations to be enacted for Type III supporting organizations will provide rules that increase confidence in the governance of such organizations, while at the same time do not decrease or harm the effectiveness of non-abusive Type III supporting organizations. We appreciate your consideration of our comments and welcome the opportunity to discuss them further with you.